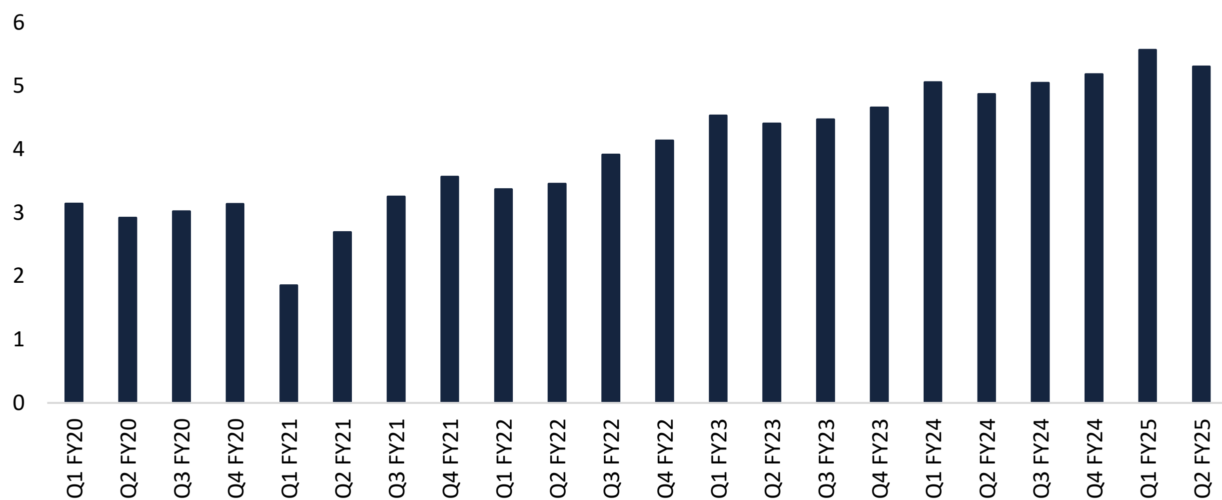
What is the data telling us

After three years of solid growth post-covid, the economy is showing some signs of moderation. The earnings picture emerging after the first six months of this fiscal corroborates this assessment. Top line growth has been weak across the board. The corrective action we have seen in the market over the last few weeks has come about against this backdrop.

Some of the high frequency indicators are worth examining at this stage.

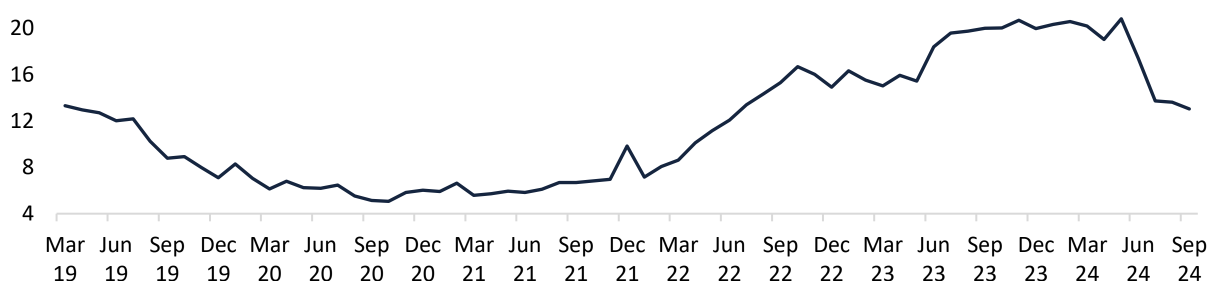
Quarterly GST Collection (Rs. Trillion)



Source: Bloomberg, Spark Fund Research

The GST collections seem to be reaching a plateau, and we won't be surprised if we get some nasty surprises in the next two quarters.

Bank credit y-o-y growth (%)



Source: Bloomberg, Spark Fund Research

The lending momentum is showing a sharp decline as well.

The corporate results for Q2 that have hit the tape in October broadly confirm that growth is moderating. The ongoing market correction is beginning to look like something more meaningful than anything that we have seen post-covid. This is already the steepest correction we have witnessed since the fall from Sept/Oct 2021 to August 2022 which coincided with rising rates in the US and the Ukrainian war. How is this different?

Two points deserve to be called out

1. This time, earnings moderation is one key catalysing force on the downside. This is crucial.
2. We had a steep mid/small cap rally and a high degree of complacency had set in.

Over the last few months, we have been highlighting some of the risks that have been building up. The data that is now flowing through is broadly consistent with the picture we saw in front of us.

Which sectors or segments look most vulnerable? Was that a major top that we saw in the economic cycle?

Fault lines in the consumer sector

We dwelt on the K-shaped recovery in June 2023 and concluded it is for real and held out that the rising stroke in the K is the line that can keep the economy ticking. While that has been the case for some time, the data is telling us that the weak stroke of the K is beginning to hurt.

The consumer sector

For many companies, the revenue growth is not even able to match nominal GDP. The picture is worse when we consider the revenue growth in the current year.

Companies	FY19-25E CAGR (%)	FY15-25E CAGR (%)	H1FY25 (y-o-y%) growth
Marico	6.3	6.3	3.1
Godrej Consumer Products	6.1	5.9	7.7
Tata Consumer Products	15.9	8.2	18.2
Dabur	7.3	5.2	-0.5
Colgate-Palmolive (India)	5.8	4.6	11.4
Nestle India	10.4	7.5	2.5
Britannia Industries*	8.8	8.8	3.7
Hindustan Unilever	8.4	7.1	1.8
Page Industries*	10.0	12.6	3.9
Titan*	19.5	17.0	9.9
Asian Paints*	11.6	10.1	-2.9
Berger Paints*	12.0	10.7	2.4
Havells	13.6	15.3	18.5
Avenue Supermarts	20.0	24.9	16.2

*Note: Latest estimates as on 31-10-2024, Nestle data has been recalculated on FY basis. *Companies whose Q2 Earnings are not yet released, Q1FY25 (y-o-y%) growth is taken.*
Source: Ace Equity, Bloomberg, Spark Fund Research.

This sector is hurting now. Let us examine the data for some Chinese consumer companies at a time when the Chinese economy grew at an average of 6.6% (ten years) and 5.4% (five years).

Chinese Consumer companies

Companies	Sales CAGR (%)		Profit CAGR (%)		Current P/E(x)
	5 Year	10 Year	5 Year	10 Year	As on 31-10-2024
Kweichow Moutai	14	18	16	17	23.5
Tencent Holdings	14	26	8	22	23.5
BYD	36	28	61	49	22.5
Tingyi Cayman Islands	6	2	5	2	17.7
ANTA Sports Products	21	24	20	23	16.4
Haier Smart Home	7	12	17	15	14.9
Midea Group	7	12	11	20	13.7
Alibaba Group Holding*	28	38	3	24	13.1
Hengan International Group	3	4	-6	-1	8.2
Samsonite International	1	8	14	11	7.8

*Note: 5Yr CAGR, 10Yr CAGR is as of CY18-23 and CY13-23 respectively. * Calculated as FY19-24 and 14-24.*
Source: Bloomberg, Spark Fund Research.

The writing on the wall is clear. Chinese stock valuations have been far lower. While Indian stocks may have deserved a certain premium for a number of reasons, the premia cannot sustain in the face of such tepid growth. Not for long.

It is not even that the Indian consumer is hurting overall. It is more a case of the consumer not being able to stand the weight of the load of options in front of her. Consumer companies are not able to keep up unless they are in niche areas (ecommerce, leisure – something with a unique offering to the consumer).

Our take is that the slowdown will not stop midway, Worse is in store ahead. This adjustment is unlikely to be easy.

Fault lines in consumer financing

RBI has been warning everyone. There is a problem in the so-called bottom of the pyramid (the downward stroke of the K). Microfinance companies have revealed the cracks. Banks with aggressive positioning in retail lending have shown rising stress in Q2. Given that the recognition of slippages is a lag indicator, the full impact of the stress is yet to be revealed. PSU banks have not yet revealed the stress even as the retail loans have been growing fast for these names. Our assessment is that things will get worse before getting better. However, not everyone may hurt and that is a point worth noting.

Is this the end of the road for the benign credit cycle?

We don't think so. Once again, let us look at some data.

Metals

Companies	D/E(x)			ROE (%)			ROCE (%)		
	FY14	FY19	FY24	FY14	FY19	FY24	FY14	FY19	FY24
Hindalco	1.6	0.9	0.6	5.7	9.8	10.1	5.5	10.9	11.0
Jindal Steel & Power	1.6	1.2	0.4	8.7	-7.7	14.3	8.2	2.2	13.9
JSW Steel	1.6	1.4	1.1	2.0	24.1	12.6	9.1	20.2	14.0
NALCO	0.0	0.0	0.0	5.3	16.5	14.5	9.3	26.0	19.8
SAIL	0.6	1.1	0.6	6.2	6.1	5.5	6.6	8.0	7.3
Tata Steel	2.1	1.6	0.9	10.0	14.7	-5.1	9.7	14.6	3.6
Vedanta	1.1	1.1	2.8	22.9	15.5	21.6	16.6	15.4	25.2

Source: Ace Equity, Spark Fund Research

Power

Companies	D/E(x)			ROE (%)			ROCE (%)		
	FY14	FY19	FY24	FY14	FY19	FY24	FY14	FY19	FY24
JSW Energy	1.5	0.9	1.5	12.2	6.0	8.8	13.6	9.2	8.8
NTPC	0.9	1.6	1.5	13.5	13.1	13.9	11.1	6.5	10.6
SJVN	0.3	0.2	1.4	12.8	12.5	6.5	12.4	15.5	5.3
Tata Power	3.4	3.0	1.5	-0.3	17.2	14.0	8.4	12.1	13.0
Torrent Power	1.5	1.1	1.0	1.8	10.9	16.4	6.6	12.2	15.6

Source: Ace Equity, Spark Fund Research

The debt levels in these core sectors shows a healthy picture. The balance sheet metrics have shown a noteworthy improvement.

Let us look at the few of the leading private banks. We see no stress here.

Companies	GNPA (%)			Credit Cost (bps)		
	FY14	FY19	FY24	FY14	FY19	FY24
Axis Bank	1.3	5.3	1.5	99	257	45
HDFC Bank	0.1	1.4	1.2	58	102	115
ICICI Bank	3.0	7.4	2.3	84	358	33
Kotak Mahindra Bank	2.0	2.1	1.4	60	51	45

Source: Ace Equity, Spark Fund Research. Note: Credit cost is a calculated number.

From what we can see, we are in the middle of a healthy but powerful mid-cycle correction. This should set the base for the next leg of growth. The duration of the corrective action in the economic cycle is hard to pin down. However, we are already well into it. The voices of denial need to get real. Excesses – including excess returns in stocks – need to moderate. This is where the possible disconnect is.

What gives?

The market may have enough steam left for reasonable returns particularly after the correction finds a base. The definition of what could be considered as reasonable market returns has undergone an upward shift thanks to the never-ending chorus of how exciting the India growth story is and how strong the Indian retail investor (SIP) is. The trend rate of return for the future is hard to predict. But watch out for a meaningful mean reversion. It does not help choosing convenient past periods which have pushed up the mean rate of return to the greed rate of return. The following factors are coming together to catalyse this process:

1. Earnings moderation in India and a mid-cycle adjustment.
2. Change of guard in the US.
3. Realisation that liquidity is a two-edged sword (FPI selling is beginning to outgun the domestic flows even if this could be a passing phase).
4. Lack of global growth drivers and the fact that geopolitical risk is likely to settle down at an elevated level.

In such an environment, earnings visibility and predictability as well as earnings resilience will qualify as places to hide. We need to find some level ground before India can resume the business of defying gravity.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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